Taxation of Property Transfers

October 2003

Introduction

The value of farm assets can be significant, and in many cases forms the basis from which the owners develop retirement plans. When farm property is transferred to heirs or sold to another individual, it is important that such transfers and sales are consistent with larger goals while at the same time minimizing the associated tax liability. Currently, the two main provisions that benefit farmers from a tax point of view are the **Rollover Provision** and the **$500,000 Lifetime Capital Gains Exemption**.

The techniques and examples used in this discussion are general in nature and will highlight the benefits of planning such transactions ahead of time. As always, it is prudent to seek professional tax advice.

The Farm Sale

The tax treatment of income from the sale of farm assets is dependent upon a number of factors. There are four basic questions to consider:

1. **What is the Sale Price?**
   - In determining the overall sale price of a farm, the price of the various farm assets should be set out in a sale agreement. By having such an agreement, the determination of any tax liability can more accurately calculated.

2. **What is being Sold?**
   - **Capital Property (Gains and Losses)** – Payment of income tax on capital gains began January 1, 1972. Capital gains and losses are calculated on the difference in value between the adjusted cost base (ACB) and the sale price of capital property such as farmland, rental properties, stocks and personal property. Capital gains on depreciable property such as machinery, equipment, and buildings are subject to tax, but losses cannot be used for tax purposes.

     For property obtained before 1972, the ACB is the greater of original cost or the December 31, 1971 value. If obtained after 1971, the ACB is the purchase price plus costs. For land, the cost base is adjusted by adding the cost of any non-depreciable capital improvements, such as a dugout. Legal and realty fees are also added to the adjusted cost base. The ACB of buildings are increased by any capital improvements or additions beyond just the normal maintenance and repair.

   - **Depreciable Property (buildings, equipment, and vehicles) Part XI Assets (post 1971 assets)** – When Part XI Assets are sold, there is the potential of having to report recapture of capital cost allowance and/or capital gain.

     Part XI Assets are broken into classes and each class of assets has an amount that represents the value remaining after all accumulated tax depreciation (Capital Cost Allowance) has been deducted. This is called the undepreciated capital cost (UCC). Each time an asset is sold, the lesser of the original cost and the sale price is subtracted from the UCC. Recapture of capital cost allowance (CCA) occurs when the sale of the assets causes the UCC balance of the class to fall below zero (i.e. a negative balance is created in the class). This means the assets have not depreciated as much as you claimed. Therefore the difference must be "recaptured" and reported as income.

     Capital gains can occur on buildings, machinery, and equipment. The capital gain on buildings can be offset with the capital gains exemption, if available. Machinery and equipment are not eligible for this exemption.

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If you sell all the items in a class you must keep track of the sale price of individual assets. This is because the proceeds must be allocated on an asset by asset basis in order to calculate the capital gain. You will also need to know the original cost of each item sold.

- **Inventory Sales – Tax Filed on a Cash Basis**
  If it is a cash sale, the proceeds from the sale of inventory are included as income in the year payment is received. If the inventory is exchanged for an open account or note, the amount owed for the inventory is an account receivable and payments are included in income as they are received. If, however, you are selling land at a time when the crop is unharvested and growing in the field, the value of the inventory can be added to the sale price of the land.

- **Marketing Quota** – The Canada Customs and Revenue Agency classifies quota as *Eligible Capital Property* and changes in quota holdings affect your *Cumulative Eligible Capital (CEC) Account.* The sale of quota can generate both recapture of depreciation and capital gains. The principle of recapture on quota is similar to that of depreciable property. When eligible capital property such as quota experiences a capital gain, it is called a **deemed taxable capital gain**. This deemed taxable capital gain is eligible for the $500,000 Capital Gains Exemption and is not subject to **Alternate Minimum Tax (AMT)**.

- **Principal Residence** – Farmers may have one home identified as their principal residence. The sale of a principal residence does not attract any tax liability. There are two ways in which to handle the sale of the farm residence:

  A. The house and ½ hectare (ha) of land can be designated as your principal residence, which is then exempt from tax on any associated capital gains. More than ½ ha can be declared, but to qualify it must be shown to be necessary for the use and enjoyment of the property. A reasonable allocation of the sale price between the house and ½ ha, and the farmland, must be made.

  B. The second method allows you to deduct from the total capital gain on the entire property (house and farmland), $1,000 plus a $1,000 for every year since 1971 that that house was your principal residence. Under this method an allocation of the capital gain on the house and ½ ha does not have to be made.

3. **To Whom is it being Sold?**
   - Depending on whom the farm is being sold to, many special considerations and rules come into effect. For a spouse, children or even great grandchildren there are rollover provisions available that may fit the sale agreement needs. For sales to a partnership, corporation, etc. other strategies are available which will be discussed further in this document.

4. **What Will Be the Income in the Year of the Sale?**
   - If the net result of your sale of property is a sizeable Capital Gain there is another tax that may be levied in the form of the **AMT**. This tax can, however, be recovered if you have regular taxable income in future years. Further information on Alternative Minimum Tax can be found in the **Information Update: Taxation – "Alternative Minimum Tax".**

Rollovers

When eligible property is transferred between two parties and the recognition of a capital gain, loss or recaptured depreciation is deferred for income tax purposes; this is defined as a **Rollover**. It is important to remember that income tax is deferred and payment of tax will occur when the property is sold at a future date. Under the current rollover provisions, payment of such tax could theoretically be postponed indefinitely as the farm is passed from one generation to the next. Rollovers are likely to occur when:

- Any capital property is transferred from an individual to a spouse or common-law partner or to a spousal or common-law partner trust.
- Farmland and/or depreciable property used in the business of farming are transferred from a parent to a child.
- Any property transferred to a partnership.
- Any property (other than land inventory or real property owned by a non-resident) is transferred to a corporation.
- A share in a family farm corporation or an interest in a family farm partnership is transferred to a child.
- A share in a small business corporation is transferred to a child.
- Eligible capital property (i.e. milk quota) is transferred to a child.
- Any property received by a child on a rollover is transferred to a parent because of a child's death.

Capital Gains Exemption

Farmers can realize up to $500,000 of capital gains on qualifying farm property without being subject to tax by offsetting their gains with the capital gains exemption (CGE). If the taxpayer and his/her spouse or common-law partner own the farm property jointly, each may be entitled to this tax-free gain.

The CGE applies only to the gains on certain assets. Generally speaking these assets are:

- Land
- Quotas
- Interests in certain farm partnerships
- Shares of certain farm companies

Note: When property is transferred to a spouse or common-law partner, a child, a Canadian Controlled Private Corporation or a Canadian partnership, the transfer value of the property can fall anywhere between the tax cost base and ***fair market value (FMV).*** *For property purchased after 1971, the cost is the amount paid when the purchase was made whereas for property purchased prior to December 31, 1971 (V-Day), the cost is either the median amount or valuation day amount.* Further information on determining a cost base can be found on the **Information Update – "Capital Gains or Losses".**

Transfer of Property to a Spouse or Common Law Partner

Since 2001, "spouse and common-law partner" has replaced the reference to "spouse" in the *Income Tax Act.* While the term "spouse" applies to someone to whom you are legally married, a common-law partner (for income tax purposes) is "a person of the same or opposite sex with whom you live and have a relationship, but who is not your spouse". In addition, at least one of the following has to apply. He or she:

- is the natural or adoptive parent (legal or in fact) of your child;
- has been living and having a relationship with you for at least 12 continuous months; or
- lived with you previously as your spouse or common-law partner for at least 12 continuous months.

Capital Property gifted or sold to a spouse or former spouse, a common-law partner or former common-law partner or a spousal trust or common-law-partner trust may be transferred at the taxpayer's adjusted cost base or, in the case of depreciable property, at its Undepreciated Capital Cost. Any taxable gains or recaptured depreciation that would otherwise trigger income tax payable is now deferred until the recipient spouse or common-law partner disposes of the property.

An election may be made not to have this provision apply as the situation may warrant that the transfer take place at fair market value (FMV) to take advantage of the current Lifetime Capital Gains exemption of $500,000.

Transfer of Property to a Child

To undertake a rollover of property to a child, four requirements have to be met for the transaction to be valid:

1. The taxpayer, the spouse or common-law partner, or a child must have been using the property in the business of farming.
2. The farm property must be transferred to a child of the farmer. A child is defined as the farmer's child, grandchild, great grandchild, stepchild, adopted child, or child of a spouse or common-law partner. For transfers since 1983, the definition of a child also includes a person who before age 19, was wholly dependent upon and under the custody and control of the taxpayer.
3. The property must be land or depreciable property situated in Canada. There are two additional considerations for depreciable property.
   - property depreciated under the declining balance method (Part XI) qualifies for rollover to the child at its Undepreciated Capital Cost (UCC).
   - property depreciated under the straight-line method (Part XVII) must be transferred at its fair market value (FMV). Once straight-line property has been transferred it must now be depreciated using the declining balance method.
4. If the taxpayer dies, the rollover provision may be used provided the child has the right to absolute ownership of the farm property within 36 months of the date of death.

In situations in which the above four conditions exist, no capital gain, recapture of depreciation or any other income will occur as long as the sale proceeds are not greater than:

- the adjusted cost base in the case of capital property such as land and buildings;
- the undepreciated capital cost in the case of depreciable property such as machinery and equipment; or
- 4/3 times the cumulative eligible capital amount in the case of eligible capital property such as milk quota.

It may be advisable to transfer Non-Depreciable Capital Property such as land and buildings at a value greater than the adjusted cost base. This serves two purposes. Firstly, it sets a higher cost base for the purchaser and reduces potential tax liability in the future, and secondly, it triggers capital gains, which allows the vendor to make use of the capital gains exemption.

Attribution Rules – If you transferred property to your spouse or common-law partner (as above), and your spouse or common-law partner later disposes of the property, any capital gains (or losses) realized on such property are attributed to you for tax purposes. This attribution rule also applies to any business income (or loss) resulting from the property. Further clarification and details on attribution rules can be found in Revenue Canada's interpretative bulletins, IT 510 and IT 511R.

In the case of transferring property (using the rollover provision) to a child (related minor) while the parent is still living, attribution rules may also apply.

Attribution rules do not apply to spouses, common-law partners or related minors in the following situations:

- The recipient pays fair market value for the property.
- The property was transferred for a loan equal to the fair market value of the property.
- The spouses or common-law partners are living apart.
- Either the taxpayer or the recipient dies.
- The taxpayer ceases to be a resident of Canada.
- In the case of the recipient being a related minor, if the related minor turns 18 years of age by the end of the year.

Estates

Executors of estates have considerable flexibility in setting values at which assets are transferred to heirs of the estate. Values can be established between the ACB and the FMV for transfers to both spouse and children. This allows the executors to use rollover provisions and the capital gain exemptions to best advantage. Further information on the tax implications upon death can be found in the **Information Update – "Taxing the Deceased Farmer".**

Transfers of Property to Corporations or Partnerships

In some cases, it may be advantageous to incorporate the farm business or to form a partnership.

As in the case of transferring farm property to a child, taxpayers transferring capital property to a corporation may elect to have, as deemed proceeds of disposition, amounts less than Fair Market Value. The deemed proceeds become the cost of acquisition for the corporation and the corporation assumes the taxpayer's future tax liability. This is commonly referred to as a Section 85 rollover. Property transferred to a corporation is exchanged for some consideration, which may include shares in the corporation, cash and/or shareholders loans.

Inventory (i.e. grain, livestock) can be transferred to a corporation on a tax-deferred basis. If preferred shares are taken back from the corporation as consideration, the farmer receives full value (for tax purposes) for the inventory and the corporation pays the tax when the inventory is sold. This may be an advantage if it is the intent to gift these shares to children but may be a disadvantage to the shareholders at large as the corporation will have a tax bill to contend with when it sells the inventory.

Alternatively, if the inventory were sold to the corporation in exchange for a demand note of equal value, the farmer and the corporation would have the following advantages:

- The corporation will have a deduction when it makes payments on the loan. This will be a benefit to all shareholders.
- It will allow the farmer to spread income over a number of years.
- The resulting payments to the farmer are eligible income for calculating RRSP contributions.

Similar rules apply when transferring assets into a Canadian partnership in that it can be accomplished on a tax deferred basis…i.e. a rollover. Consideration for ownership is taken back in the form of partnership interests instead of shares.

A proprietor may roll assets into a corporation or a partnership at a value that triggers no tax or at a value that triggers enough income to use up previous capital losses. In both cases, a capital gain triggered on Qualified Farm Property may be offset by the capital gains exemption.

If the partnership or corporation pays for all or part of the asset(s) transferred by assuming related debt or by owing an amount to the partner or shareholder, the elected transfer value cannot be less than this amount. This higher value may result in more tax being paid.

Transfers of Farm Corporations and Farm Partnerships

The shares of a family farm corporation or an interest in a family farm partnership may be gifted to children on a rollover basis or may be sold at any value between the adjusted cost base and fair market value. The definition of a "share" in a family farm corporation is:

- A share of the capital stock of a corporation that carries on the business of farming in Canada.
- The corporation must use at least 90% of its property in the carrying on of the farming business.
- A family member must be actively engaged in the farming operation.

Transfer of Farm Inventory

There is **NO CAPITAL GAINS EXEMPTION** or rollover provision in transferring inventory to a spouse or child. Inventory that is gifted is deemed to have been sold with the fair market value of such a transfer deemed as income for the parent and an allowable expense for the child. To manage the potential tax implications the following options may be considered:

- When selling cattle to a child, **lend** the total purchase price over a ten-year period. By lending the purchase price this creates a debt instrument called a producer's note. This in turn provides a ten-year **"reserved mechanism"** which gives the parents equal annual payments of the debt. The parents potential tax payable can then be spread over this ten-year time frame rather than being all received in one year. If the intent of the parent was to gift the cattle, then these annual payments can be gifted back to the child.
- If the parent uses a producer's note, as in the above example, to sell cattle inventory to the child, upon the parent's death, the unpaid balance will become part of the deceased's *rights or things* and may be transferred to a beneficiary. If the beneficiary is the person owing the unpaid balance, this will have the effect of forgiving the loan with no tax liability accruing to the deceased parent's estate.
- Upon death, the legal representative of the taxpayer may transfer or distribute farm inventory (in the form the rights or things) to the beneficiary(s) of the estate, reporting the associated income, when sold, on the beneficiary's tax return.
- Use inventory as payment-in-kind for labour provided on the farm by the child.

Trusts

Trusts are a legal arrangement in which a trustee manages the assets of the trust for another's benefit. A farm business can be transferred to an inter vivos trust that is created while the farmer is still alive or testamentary trust that is created upon the farmer's death. The trust is usually set-up so that the surviving spouse continues to receive income from the farming business for life. Upon the spouse's death, the farm property can then be divided amongst the remaining children.

Revenue Canada provides specific rules for the establishment and uses of trusts. If these rules are met then the spousal rollover and farm rollover can potentially be combined to defer tax.

Life Estates

If a farmer is ready to retire and does not need to sell the property to provide for retirement, the creation of a **life estate** is an option to examine. To set up this arrangement, a farmer would "partition" the property, retaining a **life interest** and transferring the **remainderman** interest to a child or children.

Life interest – is a legal term meaning the right to the use and enjoyment of the property and any income earned by the property.

Remainderman interest – is also a legal term meaning the right to title and the right to a life interest on the death of the present holder of the life interest.

The parents then maintain a right to the income (i.e. rental income paid by the child) from the property as long as they live. Upon their death then the life estate title merges into the remainderman title. Benefits to this approach are:

- Subsequent changes in tax law will not affect the rollover.
- Where a farmer wishes to retire, but does not have any children interested in farming, this rollover can be completed while still in the business of farming.
- The child can use the land as if it was leased with the knowledge that they will eventually acquire full title.
- As the land will not become a part of the estate, probate fees could be reduced.

As this arrangement can become complex, professional help should be obtained to put this in place.

Notes

Notes

For Further Information Contact Your Local Manitoba Agriculture and Food Office.

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